profitable (and efficient) than Japanese banks, might have more success than their Japanese competitors who will continue to face constraints due to loan losses.[34] Although the option of merging failing domestic with foreign banks is politically unlikely, it would present savings for the Japanese government at a time when its deficit to GDP ratio is expected to become the second highest in the G-7.[35]

In any case, domestic bank mergers precipitated by the financial difficulties are already changing the character of Japan's financial industry.[36] Previously, Japan's largest six banks were very similar in size when measured by total assets. The merger of Mitsubishi and Bank of Tokyo, and a rumoured merger of Sumitomo with Daiwa,[37] would increase these banks' size to such an extent that they would pull ahead of the pack. There is speculation that these mergers will precipitate others within the industry, leading to even bigger Japanese banks. The Japanese financial industry might become centred around several banking groups that are even larger than ones in evidence today. Without significantly increasing transparency in the regulatory system, increasing banks' size and range of activities could be damaging since they would be able to hide poor management practices even more effectively. If reforms get derailed, this could lead to further instability in the Japanese financial system with attendant considerations for the international system. As is evident from recent events, size is not insurance against crisis.

[34]The Japanese banks have the lowest profitability in the G-7. (OECD, *OECD Economic Surveys: Japan,* November 1995, p. 58.)

[35]The OECD projects that Japan's general government deficit as a percentage of GDP will reach 4.8 per cent in 1996, second only (in the G-7) to Italy's projected 6.0 per cent. Projections for Canada and the U.S. for 1996 are, respectively, 3.1 and 1.5 per cent. (OECD, *OECD Economic Outlook,* December 1995, p. A33.)

[36]The type of business activities Japanese banks can engage in has also changed with the advent of mergers, as the major banks have been able to maintain the business functions of their new "partners". For example, the separation between trust business and traditional banking activities has ended and banks are now allowed to engage in trust activities, such as fund management, through their trust subsidiaries. Historically, deregulation in the Japanese financial industry has been slow, conservative and measured. The current financial crisis might serve to quicken the pace.

[37]Sumitomo purchased Daiwa's U.S. assets after the latter bank was barred from the U.S.. The U.S. sale is rumoured to be a prelude to a merger between the two banks. (*Financial Times,* January 30, 1996, p.1.)